WASHINGTON STATE
INVESTMENT BOARD

STATE INVESTMENT BOARD
BOARD ADOPTED POLICIES

POLICY NUMBER: 2.10.100

EFFECTIVE DATE: 7/1/02

TITLE: Public Markets Equity – Retirement Funds

SUPERSEDES: 10/25/01

BOARD ADOPTION: 6/20/02

APPROVED: Joe Dear

PURPOSE:

This document outlines the investment policy and objectives for the Public Markets equity segment of the State Investment Board (SIB) Commingled Retirement Fund portfolio and supersedes any prior Board adopted policies. This policy and objectives allow for sufficient flexibility in the management process to capture investment opportunities, yet provide parameters that will ensure prudence and care in the execution of the equity investment program.

POLICY:

Strategic Objectives

Within the context of available investment opportunities, the Board's assessment of risk, and the principle of diversification, the SIB's asset allocation is to be managed over time to maximize return at a prudent level of risk (RCW 43.33A.110 and 43.33A.140).

To achieve this objective, the Public Markets equity program seeks to:

1. Achieve the highest return possible consistent with the desire to control asset volatility.

2. Ensure protection for long-term liabilities, since shorter-term liabilities are more suitably protected by lower volatility instruments such as fixed income securities.

3. Provide diversification to the SIB's overall investment program.

General Strategies

1. The Public Markets equity portion of the retirement fund includes strategies in the U.S., developed international, and emerging markets.

2. A mix of external managers approved by the Board will be used to implement the equity program.

3. Passive index funds will be used in markets that are generally efficient to promote a diversified structure, while controlling risk and minimizing costs.

4. Active, structured or specialty managers may be used to invest in markets that are less efficient and should actively seek to enhance returns while managing risk.

Investment Approach and Objectives

The Public Markets equity investments will be managed to the asset allocation targets and ranges outlined in the SIB Policy 2.10.050, Retirement Fund Asset Allocation, and SIB Policy 3.10.100, Retirement Fund Asset Allocation Rebalancing. The targets are long-term and may deviate in the short-term as a result of interim market movement and market impact costs of implementation.

A. Domestic Equity

Since the U.S. equity markets are generally efficient, the domestic equity portfolio is entirely (100 percent) passively managed. Over time, the domestic equity portfolio should closely track the return of a specified broad U.S. market benchmark, currently the Wilshire 5000 index.

B. International Equity

Non-U.S. markets are generally less efficient than the U.S. market; therefore, more active management will be included in the approach taken with international markets. The weightings of the developed markets and emerging markets elements of the non-U.S. equity program will be similar to the weightings of the MSCI All Country World Free ex. U.S. index (ACWI Free ex. US). The ACWI Free ex. US will also serve as the benchmark for the SIB's entire non-U.S. program.

1. The *developed international markets* portfolio will be invested in approximately equal amounts to the active and passive strategies. The portion that is passively managed will represent a diversified core portfolio which closely tracks a broad developed markets benchmark, such as the Morgan Stanley Capital International (MSCI) Europe, Australia, and Far East (EAFE) + Canada index.

   The actively managed portion of the international program seeks to hire managers that are willing to deviate from the benchmark and, thus, strive to markedly exceed the returns of the passive benchmark. The active portion of the program includes firms that manage large portfolios, as well as firms that manage smaller portfolios. The SIB anticipates that each of the firms will increase their asset size, client base, personnel and expertise. Over time, the SIB will have the advantage of participating in the growth of these managers, especially the firms with smaller portfolios.

2. Since *emerging international markets* are even less efficient than the developed international markets, the SIB will actively manage 70 – 75 percent of its emerging markets exposure. The benchmark for the active managers is the MSCI Emerging Markets index.

3. The emerging markets passive international equity portfolio (about 20 – 25 percent of the emerging markets allocation) uses a liquidity tier strategy in which the country weightings of the portfolio are not based on the index weighting, but on the liquidity of the country/securities. After the individual country weights are established, the exposure to each country is achieved by investing in indexed country funds. The passive emerging markets portfolio should reasonably track the liquidity tier strategy.

Equity Manager Guidelines

1. Each equity manager will have guidelines that describe the specific investment approach and general strategies to be used in the management of the assigned assets. Equities will be invested based on general allocation targets and market conditions.

2. Permissible public market equity investments include the common and preferred stock of publicly-traded companies in the U.S. and non-U.S. markets. Managers may use derivative instruments only in accordance with the SIB policies and manager guidelines. Specialized use of derivatives by managers must have prior approval by SIB staff on a case-by-case basis. Managers' use of derivatives for speculation is specifically prohibited.

3. The following transactions are prohibited: uncovered short sales, portfolio leveraging or trading on margin (not applicable to initial margin on futures transactions), straddles, naked options, and any other transactions prohibited by the statutes or the SIB.

4. The developed markets international managers may invest in small capitalization stocks and/or in a specified percentage of emerging markets securities.

5. The Board's long-term view of international equity investing and currencies eliminates the need for a currency overlay program; however, the Board will allow individual international managers to manage the currency exposures related to their portfolio.

Reporting

1. SIB staff will report equity investments and allocations to the Board monthly.

2. Appropriate consultants and/or staff will report investment structure and performance to the Board quarterly.

3. As warranted, staff will report changes to the investment managers and significant deviations in performance.

RESPONSIBILITIES:

State Investment Board - Responsible for approving the strategic policy.

Public Markets Committee - Responsible for reviewing and recommending strategic policy to the Board. The equity policy should be reviewed at least annually. The Public Markets Committee is responsible for monitoring the equity allocation relative to this policy, and the allocation and rebalancing of the managers' portfolios

SIB Staff - Responsible for implementing policy, monitoring the investment managers' asset class structure, managing the overall Public Markets equity program, and reporting to the Public Markets Committee and the Board.

Original Policy Adopted 6/29/81
Revised 8/9/82
Revised 11/14/83
Revised 9/15/92
Revised 11/18/93
Revised 7/21/94
Revised 9/16/99
Revised 10/25/01
Revised 7/1/02